Office of Chief Counsel
Internal Revenue Service

memorandum

CC:LM:HMT:[redacted]:POSTF-121003-02
[redacted]

date: JUN 14 2002

to: [redacted], International Examiner
[redacted], Team Manager, International
cc: [redacted], Team Coordinator

from: Associate Area Counsel
(Heavy Manufacturing and Transportation:Iselin)

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subject: [redacted], **Tax years** [redacted] **and** [redacted]
Section 861 Allocation of Foreign Partnership Expenses

This memorandum responds to your request for assistance dated April 10, 2002. This memorandum should not be cited as precedent.

You have asked our opinion whether your proposal to directly allocate the taxpayer's foreign partnerships' expenses to the taxpayer's distributive share of foreign partnerships' income is consistent with relevant law, and with the language of the Memorandum of Understanding executed [redacted] between taxpayer and the Service.

FACTS & ASSUMPTIONS

During the audits of [redacted] ("[redacted]") [redacted] and [redacted] tax years, the method of allocating and apportioning general and administrative expenses was a point of repeated disagreement between the taxpayer and the Service. In the interest of efficient resolution of this issue on future audits, on [redacted] the taxpayer and the examiner signed a "Memorandum of Understanding" ("MOU") setting forth an agreed apportionment methodology to be used in the audits of tax years [redacted] through [redacted]. The MOU provides as follows:

1. "The apportionment method to be used for General and Administrative expenses of [redacted] and its affiliated group Subsidiaries and flow through entities shall be the "gross income" of the consolidated group.

2. For example, for [redacted], the departments to be apportioned based upon the "gross income" method identified above, are the departments contained in the "Corporate Headquarters" costs runs, which were all departments contained in the cost centers beginning with the number "124". Except for, (1) those departments which contain direct costs attributed to a foreign entity or costs which are considered to be "stewardship", as defined under Section 1.861-8 of the

regulations. Those costs may be allocated under Section 482 or directly allocated to Foreign Source Taxable Income, rather than apportioned based upon consolidated gross income., or (2) (Other directly allocated U.S. expenses are also removed,)e.g. the department/departments containing the costs of real estate taxes assessed against real property existing within the United States are directly allocable to United States source income"

(MOU signed on [redacted] by [redacted] Corporate Director of Taxes, on behalf of [redacted], and [redacted] Team Manager, on behalf of the Internal Revenue Service)

On its [redacted] and [redacted] consolidated tax returns, [redacted] ("[redacted]") reported taxable income and loss from four foreign entities treated as partnerships for federal tax purposes ("the partnerships"). For purposes of determining its foreign tax credit limitation, [redacted] allocated [redacted]% of its income from the partnerships to foreign source. In contrast, [redacted] allocated only a portion of certain expenses of the partnerships (hereinafter referred to as the partnerships' "operating expenses") to foreign source. [redacted] pooled the partnerships' operating expenses with [redacted]'s general and administrative expenses, and allocated the partnerships' business expenses based on the gross income of the [redacted] consolidated group. As a result, the majority of the partnerships' operating expenses were allocated to U.S. source.

During the ongoing audit of [redacted]'s [redacted] and [redacted] tax years, the examiners expressed an intent to propose an adjustment to the taxpayer's partnership expense allocation in order to directly allocate the foreign partnerships' operating expenses (with the exception of interest) to [redacted]'s distributive share of the foreign partnerships' income, thereby allocating all of the partnerships' operating expenses to foreign source. The taxpayer responded that its allocation of the partnership expenses was consistent with the agreed allocation method described in the MOU, and therefore should not be adjusted.

[redacted], (b)(5)(AC), (b)(5)(DP)

[redacted]

ISSUES

ISSUE 1: Should the partnerships' expenses be directly allocated to [redacted]'s

distributive share of the partnerships' income, and therefore be treated as foreign source?

ISSUE 2: Is the Service's proposal to directly allocate the partnership expenses to partnership income consistent with the terms of the Memorandum of Understanding?

CONCLUSION

ISSUE 1: To the extent [redacted]'s distributive share of the partnerships' income is properly allocable to foreign source, and each of the expenses directly relate (and is of a type capable of being directly allocated) to [redacted]'s distributive share of the partnerships' income, the partnerships' operating expenses should be treated as foreign source.

ISSUE 2: To the extent the partnerships' operating expenses are directly allocable to the partnerships' foreign source income, the Service's proposed adjustment is consistent with the Memorandum of Understanding.

LAW & ANALYSIS

ISSUE 1:

In order to determine a taxpayer's taxable income from sources within and without the United States, the taxpayer must first allocate its deductions to a "class of gross income", and then, if necessary, apportion deductions between the U.S. and foreign source groupings within such class of gross income. Treas. Reg. § 1.861-8(a)(2). A "class of gross income" is defined as "the gross income to which a specific deduction is definitely related", and may consist of one or more items of gross income enumerated in § 61. Treas. Reg. § 1.861-8(b)(1), 1.861-8(a)(3) . A partner's "distributive share of partnership gross income" is one such enumerated item of gross income. Treas. Reg. § 1.861-8(a)(3)(xiii).

Section 702(b) provides that "[t]he character of any item of income, gain, loss, deduction, or credit included in a partner's distributive share ... shall be determined as if such item were realized directly from the source from which realized by the partnership, or incurred in the same manner as incurred by the partnership." Therefore, the source of a partner's distributive share of partnership income is the source of the income to the partnership. U.S. v. Coulby, 251 F. 982 (D.Ct. Ohio 1918). See e.g. Craik v. U.S., 90 Ct. Cl. 345 (1940) (holding that foreign source income of a domestic partnership is foreign source income to the partner).[1] The partnerships' operations must be

[1]Similarly, a partner's distributive share of partnership income shall be characterized as income in a separate category to the extent that the distributive share is a share of income earned or accrued by the

considered in determining the source of [redacted] distributive share of the partnerships' income. If all the partnerships' income is foreign source (after application of §§ 861 and 863(b)), then [redacted]'s distributive share of that partnership income is also foreign source.

A deduction shall be considered "definitely related" to a class of gross income if it is incurred as a result of, or incident to, an activity or in connection with property from which such class of gross income is derived. Treas. Reg. § 1.861-8(b)(2). Once it is determined that a deduction is definitely related to a class of gross income, the deduction is allocated to that class. Treas. Reg. § 1.861-8(b)(1). Section 1.861-8(e) of the regulations provides specific rules for the allocation and apportionment of certain deductions that are definitely related to a class of gross income. For example, legal and accounting fees are ordinarily definitely related and allocable to specific classes of gross income or to all the taxpayer's gross income, depending on the nature of the services rendered. Treas. Reg. § 1.861-8(e)(5). Stewardship expenses incurred for a corporation's benefit as an investor in a corporation may be considered definitely related to dividends received from the related corporation. Treas. Reg. § 1.861-8(e)(4).

[redacted]'s share of the partnerships' expenses maintain the same character as they had when they were incurred by the partnership. These expenses are incurred as a result of, or incident to, the activities of the partnership. Therefore, the partnership expenses are "definitely related" to the items of gross income of the partnership. Consequently, [redacted]'s distributive share of the partnerships' items of gross income constitutes the "class of gross income" to which the expenses definitely relate. [redacted]'s distributive share of the partnerships' income is a class of gross income consisting of less than all of [redacted]'s gross income. Therefore, the partnership expenses must be directly allocated to [redacted]'s distributive share of partnership income, and cannot be allocated to all of [redacted]'s gross income.

If apportionment is necessary, a deduction is apportioned by attributing the deduction to gross income in a manner which reflects to a reasonably close extent the factual relationship between the deduction and the grouping of gross income. Treas. Reg. § 1.861-8T(c)(1). However, if the class of gross income to which a deduction has been allocated is entirely U.S. source or entirely foreign source, there is no need to apportion that deduction. Treas. Reg. § 1.861-8T(c)(1). If [redacted]'s sourcing of the partnerships' income is respected, apportionment is not necessary in the present case because the class of income to which the partnerships' expenses are allocated is entirely foreign source.

A method of apportionment may not be used when it does not reflect, to a reasonably close extent, the factual relationship between the deduction and the

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partnership in such category. Treas. Reg. section 1.904-5(h)(1).

groupings of income. Treas. Reg. § 1.861-8T(c)(1). If the partnerships' income were not entirely foreign source, we would note that apportioning [redacted]'s share of the partnerships' operating expenses between U.S. and foreign source based on the gross income of the entire [redacted] consolidated group would not reflect "to a reasonably close extent" the factual relationship between the partnerships' operating expenses and the groupings of the partnerships' income. In order to most clearly reflect the factual relationship between the partnerships' expenses and the partnerships' income, any method used to apportion the partnerships' expenses should be based on the activities of the partnerships, not the activities of [redacted] and its subsidiaries, because the partnerships' expenses do not bear a definite factual relationship to the groupings of the gross income of these other entities.

ISSUE 2:

The MOU in the present case does not appear to constitute a binding closing agreement under § 7121.[2] However, some informal agreements between taxpayers and the IRS, although not constituting legally binding bilateral contracts, have nevertheless be enforced on the grounds of equitable estoppel.[3] See e.g. T.F. Tonkonogy v U.S., 417 FSupp 78 (So. Dist. NY, 1976). Whether or not the MOU is a legally enforceable document, the Service, as a matter of course, would not generally break its obligation under an MOU absent fraud, malfeasance, or misrepresentation of material fact. See § 7121.

Paragraph 1 of the MOU provides that "the apportionment method to be used for General and Administrative expenses of [redacted] and its affiliated group Subsidiaries and flow through entities shall be the 'gross income' of the consolidated group." Although the term is not defined in the MOU, we would read the term "General and Administrative expenses" as used in Paragraph 1 to mean the type of general and administrative expenses which must be ratably apportioned to all gross income because they do not directly relate to any particular class of gross income. See, Treas. Reg. 1.861-8T(b)(1). This definition is logically inferred from the reference to "apportionment method" in Paragraph 1 and the specific exclusion of directly allocable

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[2]A closing agreement under § 7121 must be executed by the appropriate persons with signatory authority on behalf of the taxpayer and the Secretary of Treasury. See IRM §§ 8.13.1, 1.2.2.

[3]Equitable estoppel is appropriate with respect to the IRS under certain limited circumstances. T.F. Tonkonogy v U.S., 417 FSupp 78 (So. Dist. NY, 1976), citing Schuster v. C. I. R., 312 F. 2d 311, 317 (9th Cir. 1962); Simmons v. United States, 308 F. 2d 938, 945 (5th Cir. 1962); Vestal v. Commissioner, 152 F. 2d 132 (D. C. Cir. 1945); Exchange & Savings Bank v. United States, 226 F. Supp. 56 (D. C. Md. 1964). "Specifically, there must be '(1) a misrepresentation by an agent of the United States acting within the apparent scope of his duties; (2) the absence of contrary knowledge by the taxpayer in circumstances where he may reasonably act in reliance; (3) actual reliance; (4) detriment; and (5) a factual context in which the absence of equitable relief would be unconscionable.'" Id.

items in Paragraph 2, both of which imply that the expenses referred to in Paragraph 1 are of a type which are subject to ratable apportionment as opposed to direct allocation.

Further, the specific reference in Paragraph 1 to "flow through entities" is not relevant to the question of whether the partnerships' expenses are subject to ratable apportionment. Paragraph 1 merely prescribes the method to be used to apportion "General and Administrative expenses", and therefore becomes relevant only after a determination that an expense can appropriately be characterized as "General and Administrative" within the meaning of Paragraph 1. The operating expenses of the partnerships, to the extent they are directly related to the partnerships' operating income, are not subject to ratable apportionment to all classes of [redacted]'s gross income, and therefore are not "General and Administrative expenses" for purposes of Paragraph 1.

As discussed above, assuming the class of gross income to which the partnership expenses are allocated (i.e. [redacted]'s distributive share of the partnerships' income) is entirely foreign source, there is no need to apportion [redacted]'s distributive share of the partnerships' expenses. Paragraph 2 of the MOU provides examples of costs which would be excepted from the apportionment methodology, including examples of costs, such as stewardship costs and costs directly allocable to foreign entities, which can be directly allocated to foreign source income. Therefore, we interpret paragraph 2 of the MOU to specifically exclude from the "gross income" apportionment methodology expenses which can be directly allocated to a specific class of income which is foreign source. In our view, the proposed adjustment directly allocating [redacted]'s share of the partnerships' expenses to [redacted]'s distributive share of the partnerships' income does not violate the language or spirit of the MOU.

CASE DEVELOPMENT & HAZARDS

We wish to emphasize the importance of the following factual determinations in support of the proposed adjustment:

[redacted], (b)(5)(AC), (b)(5)(DP)

[redacted], (b)(5)(AC), (b)(5)(DP)

, , , (b)(5)(AC), (b)(5)(DP)

, , , (b)(5)(AC), (b)(5)(DP)

[redacted]

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If you have any questions or require further information, please call attorney [redacted].

DISCLOSURE STATEMENT

This writing may contain privileged information. Any unauthorized disclosure of

this writing may have an adverse effect on privileges, such as the attorney client privilege. If disclosure becomes necessary, please contact this office for our views.

[redacted]
Associate Area Counsel
(Large and Mid-Size Business)

By: [redacted]
Attorney (LMSB)